



**2. Allowance method**

Dr. Bad Debts Expense

Cr. Allowance for Doubtful Accounts



**Estimating uncollectible accounts**

1. Percentage of total receivables:
  - management estimates the percentage of outstanding receivables that will result in losses from uncollectible accounts.
  - Example: uncollectible accounts are expected to be 4% of the accounts receivables.
2. Aging the accounts receivable method:
  - classifies the outstanding accounts by age and applies percentages to these categories based on past experience.

	Total	Number of Days Outstanding				
		0-30	31-60	61-90	91-120	Over 120
Accounts receivable	\$377,000	\$222,000	\$90,000	\$38,000	\$15,000	\$12,000
% uncollectible		1%	4%	5%	8%	10%
Estimated bad debts						

- Once the appropriate estimate for uncollectible accounts is determined, an adjusting entry can be recorded.
- The amount of the adjusting entry is the difference between the required balance and the existing balance in the allowance account.

Dec. 31	Bad Debts Expense Allowance for Doubtful Accounts (To record estimate of uncollectible accounts)	10,000	
			10,000

**Example**

Total estimated uncollectible account: 31,000  
 ADA has an unadjusted credit balance of \$1,000  
 Prepare the required journal entry

Bad Debts Expense 30,000  
     Allowance for Doubtful Accounts 30,000

**SFP presentation:**

Accounts receivable	\$200,000
Less: Allowance for doubtful accounts	<u>11,000</u>
Net realizable value	<u><u>\$189,000</u></u>

- Allowance for doubtful accounts: a contra-asset account.
- Net realizable value: the collectible portion of the accounts receivable at the statement date.

**Recording the write-off of an uncollectible**

- Actual uncollectibles are debited to ADA and credited to Accounts Receivable at the time the specific account is written off as uncollectible.

Mar. 1	Allowance for Doubtful Accounts Accounts Receivable (Write off of T. Ebbet account)	2,500	2,500
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- A write-off reduces both AR and ADA equally. NRV on the SFP remains the same.

Accounts Receivable				Allowance for Doubtful Accounts					
Feb. 28	Bal.	227,500	Mar. 1	2,500	Mar. 1	2,500	Dec. 31	Bal.	11,000
Mar. 1	Bal.	225,000			Mar. 1	Bal.	Mar. 1	Bal.	8,500

	Before Write Off	After Write Off
Accounts receivable	\$227,500	\$225,000
Less: Allowance for doubtful accounts	<u>11,000</u>	<u>8,500</u>
<b>Net realizable value</b>	<u><u>\$216,500</u></u>	<u><u>\$216,500</u></u>

## Recovery of an Uncollectible Account

When a bad debt is recovered, two entries are required:

- The entry made in writing off the account is reversed. If a partial payment is received, only that amount is reinstated.  
    Dr. Accounts Receivable  
        Cr. Allowance for Doubtful Accounts
- The collection is recorded in the usual manner.  
    Dr. Cash  
        Cr. Accounts Receivable

## Summary of the Allowance Method

1. Recording estimated uncollectible accounts
  - Any increase to the allowance is recorded as bad debts expenses
2. Recording the write-off of an uncollectible account
  - Actual accounts are written off when they are determined to be uncollectible
  - This write-off reduces the allowance
3. Recording the recovery of an uncollectible account
  - If a written-off account is later collected, the write-off is reversed and the collection recorded

## Notes Receivable

- Formal instruments of credit issued as evidence of debt.
- Normally require payment of interest and extend for 30 days or longer.
- May be current or non-current assets depending on their due dates.
- Notes and accounts receivable resulting from sales are called **trade receivables**.
  
- A promissory note is a written promise to pay a specified amount of money on demand or at a definite time.
- The party making the promise to pay is **the maker**: Note payable.
- The party to whom payment is to be made is called **the payee**: Note receivable.
- At the time a note is received, it is recorded at the principal value or **face value** with no interest added.

## Example:

On May 1, Tabusintac Ltd. (the payee) accepts a note receivable in exchange for an account receivable from Raja Ltd (the maker). The note is for \$10,000 with 6% interest due in four months.

- As time passes, interest revenue accrues on the note.
  - interest rates are always stated as an annual rate and must be adjusted for partial periods.
- **Interest = Face Value of Note × Annual Interest Rate × Time in Terms of One Year.**
- Adjusting journal entry:
  - Interest Receivable
  - Interest Revenue
  - (To accrue interest on note receivable)

### Honoured Notes

Cash  
Notes Receivable  
Interest Receivable  
Interest Revenue  
(To record collection of note and interest)

### Dishonoured Note

If eventual collection is expected:  
Accounts Receivable  
Notes Receivable  
Interest Receivable  
Interest Revenue

If no hope of collection:  
ADA  
Notes Receivable  
Interest Receivable

### Example:

Record the journal entries if:

1. Raja note is honoured
2. The notes is dishonoured and eventual collection is expected
3. The note is dishonoured and collection is not expected

- Notes receivable are reported at their **net realizable value**
- Each note must be analyzed to determine its probability of collection
- If eventual collection is in doubt, record BDE and ADA

### Statement Presentation of Receivables

- Each the major types of receivables should be identified in the statement of financial position or in the notes to the financial position or in the notes of the financial statements
- Short-term receivables are reported in the current assets section of the statement of financial position following cash and short-term investments
- Only the **net realizable value** of receivables must be disclosed

- It is helpful to report both the gross amount of the receivables and the Allowance for Doubtful Accounts either in the statement or in the notes to the financial statements
- Accounts Receivable  
Less Allowance for Doubtful Accounts  
=Net realizable value
- **Bad debts expense** is recorded in **the operating expense** section of the income statement
  - **Interest revenue** is recorded in **the non-operating section**

## Managing Receivables

### 5 steps to Managing Receivables

1. Determine to whom to extend credit
  2. Establish a payment period
  3. Monitor collections
  4. Evaluate the liquidity of receivables
  5. Accelerate cash receipts from receivables when necessary
- Loans Secured by Receivables
  - Sales of Receivables:
    - Securitization
    - Factoring

Evaluate the liquidity of receivables:

#### **1. Receivables turnover:**

Receivables Turnover= Net Credit Sales/Average Gross Receivables

#### **2. Average collection period:**

Average Collection Period= 365 days/Receivables Turnover

Accelerate cash receipts from receivables:

- Loans Secured by Receivables:
  - borrow money from a bank by using receivables as collateral.
- Sale of Receivables:
  - Securitization: transfer receivables to investors in return for cash.
  - Factoring: sell the receivables to a factor.